

# Weekly Outlook



## 12 June 2006

### Brief Market View

Irish equities slumped last week in line with weak markets around the globe. Uncertainty surrounding the future of European and US interest rates was the driver of the weakness. Speculation that the ECB would hike rates by half a percent on Thursday hit financial stocks hard. Stock rebounded modestly on Friday after the ECB's decision to raise rates just a quarter point but the market ended down by almost 6 percent on the week. London's leading shares closed down by over two percent last week as the continued sell-off on Wall Street and a slump in heavyweight miners offset M&A fuelled gains in airport operator BAA. Cable & Wireless was among the week's top gainers despite being demoted to the FTSE250. Fallout from Fed Chairman Ben Bernanke's hawkish statements continued, as investors worried that the Fed could over-tighten and drive the economy toward recession. On Wednesday the Dow Jones industrial average dropped below 11,000 for the first time since March 9.

The ECB raised interest rates by a modest quarter point to a three year high of 2.75 percent on Thursday and signaled a gradual path of further rate hikes lies ahead to curb inflation in the euro zone. ECB President Jean-Claude Trichet said that rates are still low and central bankers will "continue to monitor closely all developments" to keep risks to price stability at bay. By steering clear of the word vigilance, however, just as the ECB did after its last two rate hikes in March and December, Trichet flagged that the central bank had no immediate plans to quicken its rate tightening from a quarterly pace. Trichet's comments poured cold water on expectations of a July rate increase, leaving August 31, the next rate setting meeting after the ECB's summer break, as the most probable date for the next tightening move.

This week's US inflation data will dominate investor's attention as markets look for clues as to where interest rates will go next. The latest reports on May producer and consumer prices take on added significance after comments from Fed officials, notably Bernanke, on price pressures last week. This week also features a heavy schedule of Fed speakers, who could yet give more warnings on inflation. The chances for a 17th consecutive rise in rates after the Fed's June 28-29 policy-setting meeting currently are seen at around 80 percent, up from about 68 percent before the release of a weaker-than-expected U.S. May jobs report on June 2. The Labour Department will release May PPI on Tuesday, followed by CPI the next day. Both reports are due out at 1330 on the respective days. According to economists, headline May producer prices are forecast to edge up 0.4 percent, compared with a 0.9 percent jump the prior month. But excluding food and energy, the gauge is expected to tick up 0.2 percent after rising 0.1 percent in April. For May CPI, economists expect headline inflation to be 0.4 percent, after coming in at 0.6 percent in April. And stripping out highly volatile food and energy prices, the index is seen up 0.2 percent from a 0.3 percent rise the prior month. On the Fed front, Chairman Bernanke, who will speak before an audience of students of the American Bankers Association on Monday.

The stocks that will find most favour in the current period of market weakness are those with solid earnings with an attractive valuation and attractive yield. As a result we favour banking stocks (HBOS, Bank of Ireland), pharmaceuticals (GlaxoSmithKline, AstraZeneca), telecoms (BT and Vodafone), oil (BP, Sterling Energy) and insurance (Aviva, Legal and General). Also with the oil price weakening the stocks like Ryanair and British Airways, both of which are extremely profitable, should benefit.

The corporate earnings calendar is light this week and focus will center on the UK banking sector as we get trading updates from Alliance & Leicester & RBOS on Monday and Tuesday respectively. On Wednesday Spanish retailer Inditex will report Q1 results, while Tesco releases a trading statement.

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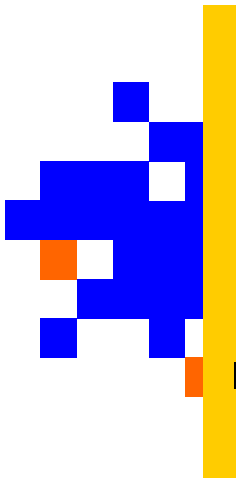
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### Earnings Calendar

Company	Date	Event
A&L	12-Jun	Trading update
RBS	13-Jun	Trading update
Tesco	14-Jun	Trading update
Inditex	14-Jun	Q1
Lloyds	19-Jun	Trading update
HBOS	22-Jun	Trading update
INWS	26-Jun	Trading update
BOI	28-Jun	Ex-div
Fyffes	Last week June	Trading update
Grafton	1st week July	Trading update
Tullow Oil	4-Jul	Trading update
CRH	5-Jul	Trading update
C&C	7-Jul	AGM
DOC	10-Jul	AGM
Iona	14-Jul	Q2
Apple	19-Jul	Q3
Trinity Biotech	24-Jul	Q2
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### Trading ideas for the week

#### INWS (€2.32) Trading statement 26th June

- Trading update : Even adjusting for the final dividend per share of 7c, which went ex on 19/04/06, INWS' share price has still fallen by over 10% in the last 2 months. This would appear to have generated an attractive buying opportunity ahead of the group's interim pre-close trading statement, which is due to be released this day fortnight, 26th June.
- Forecasts re-iterated : This is because following confirmation last Thursday at its AGM that the group's performance year-to-date remains in line with current market expectations, the upcoming trading statement is unlikely to contain any major negative surprises, but instead should provide some detail in relation to the continued strong advertising growth of the group's South African and Irish markets, as well as more cost savings to ensure further operating margin expansion in 2006.
- Earnings growth : INWS generated an eps of 15.62c for the year ended 31/12/05, representing year on year growth of 17.2%. Further circulation and advertising revenue growth (10.7% was generated for 2005), when combined with an expansion of the operating margin from 19.3% to 20%, should ensure that further double digit earnings growth is achieved in 2006. The consensus market forecast is for further 11% eps growth in 2006 to 17.4c.
- Advertising growth : The Irish market accounts for a quarter of all INWS' revenues and nearly a third of all profits. Irish newspaper advertising is expected to continue to experience double-digit growth in 2006 and 2007, with consumer spending expected to grow here by at least 6% per annum in both years.
- Product launches : Even though the 6.4% circulation growth of 2005 represented a slowing on the 10% growth achieved in 2004, further modest circulation growth should continue to be generated in 2006, helped by some new product launches.
- Attractive yield : Given these continued double digit earnings growth prospects, it is reasonable that the shares should trade at an 8% premium to the current European newspaper sector average of 13.9x 2006 eps. As a result, our current 12 month price target of €2.60 (12% upside) is based on 15x 2006 eps of 17.4c. The shares also remain on course to pay a dividend yield of c.5.2% to shareholders over the next 12 months for waiting for this upside to be achieved : BUY

#### Paddy Power (€13.05) Further upside to go

- Recent weakness: In line with the overall market weakness shares in Paddy Power have fallen significantly from their 2006 highs over the last couple of weeks. However, with Paddy Power's impressive growth story remaining intact and the upcoming World Cup in June to act as a catalyst for renewed interest in the company and the gaming sector as a whole we expect to see the shares perform strongly over the coming months. This morning we reiterate our BUY recommendation on the stock with an increased price target of €15.
- Germany catalyst: Paddy Power should benefit from this summer's football World Cup in Germany, particularly as the popularity of football betting grows. June is traditionally a quiet period for bookmakers, so this summer's competition will provide a particularly welcome boost to revenues.
- Buoyant sector: Both Paddy Power and William Hill recently released upbeat trading updates at their respective AGMs. Both bookies reiterated their full year guidance and were optimistic about their prospects for the rest of the year given the busy sporting calendar. Paddy Power did however caution that its win percentage year to date was slightly under the average midpoint of the guidance range. However, this may be partially explained by the 15% year on year growth in the number of retail outlets. Paddy Power also highlighted the strength of its online channel and gaming revenues within the online channel.
- Expansion plans : In a recent interview CEO Patrick Kennedy spoke about the bookmaker's ambitious expansion plans. Kennedy said that the company would consider growing the number of LBOs in the UK, by expanding into cities such as Manchester, Glasgow, Birmingham and Liverpool. Paddy Power currently has 50 shops in the Greater London area. He added that the company is continually looking for acquisition opportunities in new areas, particularly in the on-line area, to help protect itself from unfavourable sporting results.
- Further upside : In the wake of solid full year results announced in March and favourable outcomes at Cheltenham and the Grand National we upgrade our price target for Paddy Power from €14.30 to €15. While the shares currently trade at a 20% premium to the UK betting sector, earnings growth of c.30% per annum would appear achievable over the next 2 years, significantly stronger than sector average. Our current 12 month price target of €15, is based on 17x 2007 eps of 88c, and rates the shares at a c.10% premium to UK peers: BUY.

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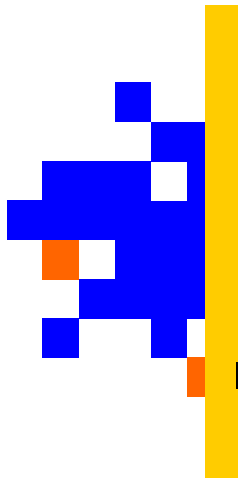
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### Trading ideas for the week (continued)

#### RBS (£17.83) Trading statement on Tuesday

- Management meeting: Following our recent investor meeting with Group Finance Director, Guy Whitaker, we upgraded our RBS recommendation from NEUTRAL to BUY. Our new 12 month price target of £20.50 (14% upside), is based on 10x 2007 underlying eps of 205p. Our 2006 eps forecast remains 190p, representing 8% growth on the 2005 result of 175.9p.
- Savings growth: In line with recent results from the UK life insurers, it was confirmed that sales of savings and deposit products are very strong currently, resulting in the bank's liability growth exceeding its loan growth. When combined with a steepening US yield curve, this should ensure that there is no further significant erosion of the group's net interest margin in 2006. This was one of the main reasons why we had been recommending some profit-taking in recent months.
- Deal risk: It was also clearly stated that all of the group's growth targets could be achieved organically from its UK and Irish, US and Chinese operations and that the current share buyback programme would continue. If the upcoming IPO of the bank's Bank of China investment results in RBS diluting its shareholding below 5%, then this could provide further reassurance that the risk of a major RBS deal over the next 12 months is very low.
- Personal exposure: Despite recent press coverage of the Q1 rise in UK personal insolvencies, it was also confirmed that RBS has suffered no material deterioration in personal lending credit quality recently. Its lower than sector average exposure to unsecured personal lending of c.7% of global loan book provides some important protection from this risk.
- Recommendation upgrade: In addition to the upcoming Bank of China IPO, which recent press coverage has reported will show a trebling of the initial value of the RBS investment a year ago, another near term positive catalyst for the RBS share price could be the bank's H1 trading statement on 12th June. Therefore, ahead of the very often seasonally strong month of June for the RBS share price, we this are this morning once again upgrading our recommendation from NEUTRAL to BUY, with a new 12 month price target of £20.50 (15% upside), which is based on 10x 2007 eps of 205p : **BUY**.

#### Ryanair (€7.20) Strong results

- FY results : Last week, Ryanair announced results for the year ended 31/03/06. Net profit and eps of €302m and 39.3c respectively, were c.1% ahead of consensus forecasts of €299m and 38.9c, and were year on year increases of 12% and 11%. The earnings growth was driven by strong passenger and ancillary revenue growth more than offsetting higher fuel costs, as the airline's average fare continued to remain resilient.
- Hedging progress : Ryanair also announced that it has hedged 90% of its fuel needs from June to October at an average price of \$70 a barrel, and that it hoped to hedge its winter fuel costs by the end of the summer. Summer bookings appear to be "moving along nicely", and it is now expecting a "5% to 10% increase" in current year net profit, if oil remains at \$70.
- Online check-in : In addition to strong revenue growth, another offset against higher fuel costs is the recently launched online check-in service. Passengers are now able to check-in both themselves and their luggage online at ryanair.com, thereby by-passing time consuming airport queues. The resultant lower airport and handling costs are expected to generate annual cost savings of c.€30m.
- Oil headwind : Our current assumption is that Ryanair has to pay an average of \$2.25 per gallon of jet kerosene over the 12 months ending 31/03/07, which is the kerosene price implied by NYMEX oil at \$70 per barrel, and that these extra fuel costs are offset by a €1 increase in the average fare from €48.60 to €49.60. This would leave Ryanair's eps flat for the 12 months ending 31/03/07 at 40c.
- Earnings sensitivity : While a greater increase than this in the average fare creates the potential for some earnings growth, every c.6% increase in the oil price above \$70 would fully offset every €1 increase in the average fare above €49.60.
- Attractive upside : However, Ryanair's continued expansion should ensure that passenger growth of at least 14% to 40m passengers is achieved during the 12 months to 31/03/07. Over the past 12 months, our continued BUY recommendation has been based on the view that given the secular growth prospects in Europe and the comparative multiples at which the US low cost airlines are rated, a multiple of 20x earnings is a fair rating for the shares. Therefore, our current 12 month price target of €8 (11% upside) is based on 20x forward eps of 40c : **BUY**.

#### Aviva (£7.26) Targeting strong international growth

- International targets : Aviva has announced some strong growth targets for its international business, under pressure to demonstrate its own growth potential, after its takeover bid for Prudential was rebuffed in March. The company has declared a stated objective of growing its existing international sales by at least 10% per annum over the next 5 years.
- Growth potential : The company also confirmed that growth in its international new business profit should at least match its sales growth. In 2005, 40% of group sales and 50% of group profit was generated outside of the UK. Aviva is targeting both its existing presence in developed markets such as France, the Netherlands, Italy, Ireland, Spain and Canada, for this sales growth, as well as building leadership positions in selected emerging markets. In Q1 2006, Aviva International grew its life and pension sales by 15% to £3.67 bn.
- Q1 sales : Aviva's overall group life and pension sales result for the 3 months ended 31/03/06 was £6.8 bn. This was 12% better than the consensus forecast of £6.08 bn, and was a year on year increase of 20%. The result was 9% better than even the top end of the forecast range of £6.24 bn.
- Bid target : Our current view is also that the end result of the recent £7.08 per share takeover offer for Prudential could be that Aviva itself ends up receiving a takeover approach. This is because the offer confirms Aviva's ambitions of building a global and US presence, and its European exposure may be of interest to AIG or AXA.
- Stand-alone value : However, even on a stand-alone basis, Aviva's share price would appear to have significant upside potential from current levels as a result of the continued buoyancy of the UK life sector. Given that Aviva's 2006 return on embedded value of 16.8% is 21% stronger than the UK sector average of 13.9%, our view is that its price to embedded value (EV) should trade at a similar premium to the UK sector.
- Attractive upside : Therefore, our current 12 month price target for Aviva of £8.50 (17% upside), is based on 1.6x 2006 EV per share of £5.30. The recent market sell-off has resulted in the UK life sector average falling by c.10% to a price / 2006 EV sector average multiple of 1.35x. Aviva shares will also pay investors a dividend yield of c.4% for waiting for this upside to be achieved : **BUY**.

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